TAX TIPS AND TRAPS
ON TERMINATION

This article seeks to address some of the tax questions which commonly arise on termination of employment, or on judgment or compromise of the ensuing dispute, and suggests how to avoid some common misunderstandings and errors.

Basic charge to tax

The charge to tax on employment income arises under the Income Tax (Earnings and Pensions) Act 2003 (ITEPA). There is no longer any such tax concept as 'Schedule E' (nor, indeed, Schedule D). The charge is imposed on employment income, which is 'general earnings' and 'specific employment income' (see s 6 and s 7). 'Earnings' includes salaries, gratuities, bonuses (s 62), expenses (s 70), the cash equivalent of the value of many employment-related benefits in kind (ss 63-220) and payments given in return for restrictive undertakings (s 225).

Termination charge

Wide though the basic charge on earnings is, it does not catch sums payable on termination of employment by way of damages, or compensation. Such sums, if not taxable as earnings, and if paid in connection with termination of employment (or a change in duties), are taxed under ITEPA s 401, but only to the extent that they exceed £30,000 (s 403).

The employee gets the benefit of the £30,000 slice only if the payment is not otherwise taxable[1]. It must always be asked, first, whether the payment has the character of earnings. Arrears of pay, bonuses already earned, holiday and sick pay, repayments of expenses and other such sums do have such a character and do not fall within the £30,000 exemption, even if paid on the occasion of termination of employment. Similarly, negotiated and agreed terms of departure where notice has already been given are likely to give rise to a payment of earnings, not of damages or compensation[2].

The payment is taxable in the year in which it is received; it is treated as received once the employee becomes entitled to require payment, even if it is in fact paid later[3].

There is only one £30,000 exemption, even if the payment is spread over two tax years, or is paid by two associated employers[4].

Contractual payments

A payment made, on termination, in consequence of the employee's entitlement under an express term of the contract of employment (eg a contractual enhanced redundancy payment) is taxable as earnings and there is no tax free slice[5]. Likewise if the term forms part of the contract of employment because it is incorporated in consequence of a collective agreement[6]. In each such case, the payment is made as a result of the terms on which the employee made his services available to the employer and is taxable, just like his salary is, as an element of his earnings, and is also subject to primary and secondary Class 1 National Insurance Contributions (NIC)[7].

Damages, compensation and compromise sums

In contrast, a sum of damages for wrongful dismissal, or of compensation for breach of a statutory right does not arise from the employment, but from the breach of the contract, or of the relevant statutory right. Similarly, a sum paid genuinely in compromise of a claim does not have the character of earnings. The employee gains the benefit of the £30,000 tax free element, and the balance is taxable as employment income (s 403). There is no charge to NIC in such a case.

Auto-PILON

Falling neatly between the two concepts of a contractual termination payment, and a payment of damages or compensation, comes the payment which, while made by the employer without any express legal obligation to do so, is in fact the result of a practice operated by the employer of making payments on termination which exceed his strict legal liability. It has long been the practice of some employers to make, without deduction of tax, a so-called 'payment in lieu of notice' (PILON), sometimes in excess of the employee's entitlement to notice, and sometimes even in circumstances where the employee has worked his notice anyway. The question in

such a case will be: Does the payment constitute earnings from the employment? If it has the character of a terminal bonus, or 'golden handshake', or reward for past services, or a payment made out of invariable habit to employees departing in particular circumstances, it is likely to be taxable as earnings. If so, the employer fails to deduct tax under PAYE at his peril. There is some reason to think that HMRC is showing an increased level of enthusiasm for taxing this form of Auto-PILON[8] and seeking accordingly to enforce PAYE against the employer. An appropriate test case can probably be expected in due course.

Grossing-up of damages or compensation

Where a payment exceeds £30,000, the employee will be liable for tax at his marginal rate on the excess over that sum. The basic rate element of the tax will be collected by the paying employer under PAYE (below), and the remainder will be collected by HMRC under self-assessment. The employee must therefore be careful to make the appropriate grossing-up claim, increasing his damages or compensation to take account of the additional tax so as to leave him, after tax, with a net sum which represents his actual loss. Accordingly, if the employee's total loss is (say) £50,000, and he will be liable for tax at 40% on the excess over £30,000, he must claim £30,000 (on which no tax is payable), plus such sum as, after deduction of 40% tax, leaves him with another £20,000, namely £33,333. So the total award would be £63,333 (subject to the further nuances of basic awards and, where applicable, the statutory cap).

PAYE

The impact of the Pay as You Earn system (PAYE) means that the taxability of a payment made to an employee is important both to him and to his employer. During employment, the employer has to deduct tax under PAYE in accordance with the PAYE Regulations[9] A modified obligation to deduct continues after termination (and after issue of the P45 certificate), when the employer must still deduct in respect of payments made to his former employer, but now only at basic rate (currently 22%)[10]. If the employer fails to deduct, the usual practice of HM Revenue & Customs is to pursue the employer, rather than the employee[11]. There are only very limited circumstances in which the employer can shift the burden back onto the employee[12].

It is most important for the incidence of PAYE to be addressed and for any compromise agreement to make provision for its incidence on the settlement sum (where relevant, to the extent that the sum exceeds £30,000). Wording such as

> *The employer is entitled and bound to satisfy the sum payable hereunder by deducting tax and accounting to HM Revenue & Customs in accordance with the Income Tax (Pay as You Earn) Regulations 2003*

should do the trick. Failure to make any provision at all may lead the disappointed employee to sue for the gross sum on the (totally incorrect) assumption that he was entitled to receive the full amount directly. Do not, without realising its full significance, make provision such as

> *The employer is bound to pay such income tax as may be payable in addition …*

The result of such a badly drafted provision (and precisely this has been done) is to render the employer liable not only for the sum which should have been deducted, but also for tax on that sum, grossed up, and also, separately, for such higher rate tax as the employee may turn out to be liable for, and for tax on that sum too, again grossed up.

Another mistake is to agree (perhaps under pressure of time) a global compromise sum under the misapprehension that the sum can, after the event, be re-allocated in a more tax-efficient way between different heads of claim. The tax character of a sum cannot be altered by calling it something different afterwards.

Interest, where awarded, is not subject to PAYE and is paid gross. It is, however, taxable in the employee's hands at his marginal rate and should be declared to HMRC under the self-assessment system.

Injury to the person

The charge on termination payments does not apply to a payment or benefit provided in connection with termination of employment by the death of the employee, nor to a payment or benefit provided *on account of injury to, or disability of*, an employee[13]. This latter provision is apt to exempt a gratuity paid by the employer to the employee on termination of employment by reason of injury. For the exemption to apply it is necessary to establish both that there is a relevant injury or disability and that the injury or disability is the motive for payment by the person making it[14]. So a payment

of compensation for loss of future earnings will not be exempted by this provision even if the loss of earnings is caused, or exacerbated, by the injury. Such compensation is paid on account of the loss, not on account of the injury. HMRC takes the - still narrower - published view[15] that the relevant injury must be the cause of the termination of employment, as well as being the cause of the payment. It seems difficult to draw this conclusion from the statutory words. While the payment must be directly or indirectly connected with the termination of the employment (in order for s 401 to be relevant in the first place), there is no justification for the assertion that the disability or injury must have caused the termination, rather than the payment.

Compensation for injury to feelings in discrimination cases will often not have the requisite connection with termination of employment to bring that compensation into charge under s 401. HMRC's published line is that 'injury' means 'physical injury'[16]. but there can be little doubt that an actual psychiatric illness would qualify as an 'injury'. There is some Employment Appeal Tribunal authority[17] for the startling proposition that all injury to feelings amounts to injury to the employee (irrespective of whether it amounts to a psychiatric illness), and that all compensation for injury to feelings is therefore exempted by s 406. The EAT's reasoning is, at least, highly suspect and might well not survive a challenge by HMRC.

Costs

The advantage to all sides which is provided by Extra Statutory Concession A81 should never be overlooked. The Concession takes a payment of legal costs out of the tax charge on termination payments under s 401. It is available if the costs are ordered by a court or tribunal, or if, under a compromise agreement they are paid directly to the employee's solicitor. Negotiations for any compromise should always address the desirability of attributing some of the settlement sum to the claimant's legal costs. It is important to comply strictly with the terms of the Concession[18]; there is no appeal from HMRC's decision that it has not been followed.

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[1] s 401(3)

[2] Richardson v Delaney [2001] IRLR 663, [2001] STC 1328

[3] s 403(3)

[4] s 404

[5] EMI Group Electronics Ltd v Coldicott [2000] 1 WLR 540. A *statutory* redundancy payment is not taxable except, under the termination provisions, if it forms part of a payment which exceeds £30,000 (see s 309). A *non-statutory* payment having the characteristics of a redundancy payment is similarly treated. See Statement of Practice 1/94 and Mairs v Haughey [1994] 1 AC 303, 66 TC 273

[6] SCA Packaging Ltd v Revenue & Customs Commissioners [2007] EWHC 270 (Ch), Lightman J

[7] Social Security Contributions and Benefits Act 1992, s 3 and s 6

[8] See the argument before the Special Commissioner in SCA Packaging Ltd [2006] STC (SCD) 426 at [170]-[172] and before Lightman J [2007] EWHC 270 (Ch) at [17]. HMRC's basic position was set out in February 2003 in its Tax Bulletin, Issue 63 http://www.hmrc.gov.uk/bulletins/tb63.htm#6

[9] ITEPA Part 11, ss 682-712 and the Income Tax (Pay as You Earn) Regulations 2003 (2003/2682)

[10] Reg 37

[11] Reg 80

[12] See Regs 72, 72A

[13] s 406

[14] Horner v Hasted [1995] STC 766

[15] http://www.hmrc.gov.uk/manuals/eimanual/EIM13610.htm

[16] In the Employment Income Manual at http://www.hmrc.gov.uk/manuals/eimanual/EIM13610.htm it is asserted that '"Injury" is construed as physical injury. It does not include injury to feelings.'

[17] Orthet Ltd v Vince-Cain [2005] ICR 374, [2004] IRLR 857

[18] The effect of ESC A81 is helpfully summarised at http://www.hmrc.gov.uk/manuals/senew/SE13740.htm